BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of	)	
	)	DOCKET NO. 17345
[Redacted],	)	DECISION
	)	
Petitioner.	)	
_____	)	

On March 26, 2003, the Income Tax Audit Division of the Idaho State Tax Commission issued a Notice of Deficiency Determination to [Redacted] ("taxpayer") asserting an Idaho income tax liability in the amount of $104,447 for the 1997 through 2000 taxable years. On May 23, 2003, the taxpayer filed a timely appeal and petition for redetermination. An informal conference was requested by the taxpayer and was held via telephone on February 26, 2004. The Tax Commission, having reviewed the file, hereby issues its decision in this matter.

I.

FACTS AND PROCEDURAL HISTORY

[Redacted] is the parent of a unitary group of companies engaged in the manufacture, distribution and sale of paints and related products. [Redacted] group of companies is headquartered in [Redacted], and is America's [Redacted] with approximately 25,000 employees and roughly $5 billion in annual sales. The group's Idaho activity consists mainly of the operation of nine [Redacted] within this state.

During March 2002 the Tax Commission's audit staff conducted an audit of [Redacted] and Subsidiaries' 1997 through 2000 Idaho corporate combined group returns. Several audit adjustments were made to those returns, resulting in a total Idaho income tax deficiency of $104,447. [Redacted] originally protested five of the audit adjustments, including the imposition of the 10% substantial understatement penalty. The company conceded the remainder of the audit adjustments and remitted payment of the tax and interest owed on the non-protested

adjustments. During the informal conference held on February 26, 2004, [Redacted]conceded another of the audit adjustments, leaving only four audit adjustments in dispute.

II.

ISSUES PROTESTED

Four issues have been raised in this administrative protest. Those issues are:

1. Business/Nonbusiness treatment of proceeds received from an insurance company relating to the modification of a casualty insurance policy.

2. Business/Nonbusiness treatment of gain recognized from the sale of an interest in a non-unitary subsidiary ([Redacted].).

3. Inclusion of two "Delaware holding companies" ([Redacted] as part of the [Redacted] unitary group.

4. Imposition of the 10% substantial understatement penalty.

This Decision will address each of these issues in turn.

III.

ANALYSIS

A. Business/Nonbusiness Treatment of Proceeds from Renegotiated Insurance Contract.

The first issue raised in this protest is whether proceeds received by [Redacted] relating to the modification of a casualty insurance policy should be treated as business or nonbusiness income. The facts relating to this issue are somewhat unclear. Based on the explanation provided at the informal conference, it is the Commission's understanding that prior to 1997 [Redacted] had an insurance policy with [Redacted] that provided casualty insurance relating to specific manufacturing plants owned and operated by [Redacted] in several different states. In reviewing that policy, officials with the insurance company were concerned about a clause that could be interpreted as covering the costs associated with the clean up of toxic spills or other

environmental catastrophes. As a result of this concern, the insurance company paid [Redacted] a significant amount in consideration for [Redacted] releasing the company from liability relating to any future environmental clean-up costs. [Redacted] treated the payment as nonbusiness income. The Commission's audit staff has recharacterized that payment as business income. [Redacted] contests that audit adjustment, claiming that the proceeds were correctly treated as nonbusiness income.

Under Idaho's tax laws, business income is defined as all "income arising from transactions and activities in the regular course of the taxpayer's trade or business and includes income from the acquisition, management, or disposition of tangible and intangible property when such acquisition, management, or disposition constitutes integral or necessary parts of the taxpayer's trade or business operations." Idaho Code § 63-3027(a)(1). Nonbusiness income is all income other than business income. Idaho Code § 63-3027(a)(4). The Idaho Supreme Court has recently held that the above quoted statutory language sets forth two separate and independent definitions of the term "business income." Union Pacific v. Idaho State Tax Com'n., 136 Idaho 34, 28 P.3d 375 (2001). According to the Idaho Supreme Court, the first definition for business income is "income arising from transactions and activity in the regular course of the taxpayer's trade or business." *Id.* at 38 – 39, 28 P.3d at 379 – 380. In addition, business income also includes "income from the acquisition, management, or disposition of tangible and intangible property when such acquisition, management, or disposition constitute integral or necessary parts of the taxpayer's trade or business operations." *Id.* These two separate definitions are commonly referred to as the "transactional test" and the "functional test."

It is clear on the record before us that the proceeds received by [Redacted] in consideration for releasing the insurance company from liability for any future environmental

clean-up costs do not qualify as business income under the transactional test. This income was not earned or generated in the ordinary course of [Redacted] trade or business activity. The Commission also finds that the proceeds are not business income under the functional test. It is true that proceeds from an insurance contract or insurance settlement can be business income if they represent the recovery of lost profits or the recovery of the value of property directly connected with the taxpayer's business operations. *C.f.* Polaroid v. Offerman, 507 S.E.2d 284 (N.C. 1998) (recovery of lost profits in tort action treated as business income). However, the proceeds at issue in this administrative protest do not appear to be related in any realistic way to lost profits or to the recovery of the value of property directly connected with the taxpayer's trade or business operations. In short, this income is not derived "from the acquisition, management, or disposition of tangible and intangible property when such acquisition, management, or disposition constitutes integral or necessary parts of the taxpayer's trade or business operations." Idaho Code § 63-3027(a)(1). It is, therefore, nonbusiness income. The audit adjustment is reversed.

B. Business/Nonbusiness Treatment of Gain from the Sale of [Redacted]**.**

1. Introduction.

The next issue raised in this protest is whether the gain recognized by [Redacted] from the sale of its interest in [Redacted] should be treated as business or nonbusiness income.

[Redacted] was created in 1991 or 1992 as part of a joint venture between [Redacted]. [Redacted] had developed and marketed throughout Europe a line of premium automotive paints and refinishing products under the brand name "[Redacted]." In an effort to gain market share for this product in the United States and Canada, [Redacted] approached [Redacted] about a possible joint venture that would utilize the extensive marketing network of [Redacted] to market and distribute the [Redacted] product line in North America. [Redacted] agreed, and this venture led to the creation of [Redacted] which was 50% owned by [Redacted]. and 50% owned by [Redacted] In 1998 [Redacted]. sold its 50% interest in [Redacted]. at a gain of approximately $12 million. The taxpayer characterized this gain as nonbusiness income on its 1998 Idaho combined group return. The Tax Commission's audit staff has recharacterized that gain as business income.

In order for Idaho to tax an apportionable share of the gain on the sale of [Redacted], that gain must meet the statutory definition of business income found in the Idaho Income Tax Act. If the gain falls within the statutory definition of business income, the analysis shifts to the constitutional limitations found in the Due Process clause and the Commerce Clause of the United States Constitution. We will first turn to the statutory considerations.

2. Statutory Considerations -- Business/Nonbusiness Income.

In 1965 Idaho adopted with slight modification the Uniform Division of Income for Tax Purposes Act (UDITPA). That uniform act, as modified, is found at Idaho Code § 63-3027. As described by the Idaho Supreme Court:

> The Act contains rules for determining the portion of a corporation's total income from a multistate business which is attributable to this state and therefore subject to Idaho's income tax. In general, UDITPA divides a multistate corporation's income into two groups: business income and

> non-business income. Business income is apportioned according to a three factor formula, while nonbusiness income is allocated to a specific jurisdiction.

American Smelting & Ref'g Co. v. Idaho St. Tax Comm., 99 Idaho 924, 927, 592 P.2d 39, 42 (1979) (citations to statute omitted), *rev'd on other grounds*, ASARCO Inc. v. Idaho State Tax Commission, 458 U.S. 307, 102 S.Ct. 3103 (1982).

Business income is defined as all "income arising from transactions and activities in the regular course of the taxpayer's trade or business and includes income from the acquisition, management, or disposition of tangible and intangible property when such acquisition, management, or disposition constitutes integral or necessary parts of the taxpayer's trade or business operations." Idaho Code § 63-3027(a)(1). Nonbusiness income is all income other than business income. Idaho Code § 63-3027(a)(4).

As indicated above, the Idaho Supreme Court has recently held that the above quoted statutory language sets forth two separate and independent definitions of the term "business income." Union Pacific v. Idaho State Tax Com'n., 136 Idaho 34, 28 P.3d 375 (2001). These two separate definitions are commonly referred to as the "transactional test" and the "functional test." The transactional test is concerned with income arising from the ordinary course of the taxpayer's trade or business operations. In contrast, the functional test is concerned with income derived from property that is utilized in or otherwise directly connected with the taxpayer's trade or business operations. *Id.*at 38 – 39, 28 P.3d at 379 – 380. Thus, there is no requirement under the functional test that the income arise from transactions and activities in the regular course of the taxpayer's trade or business. *Id.* at 39, 28 P.3d at 380. The key determination is whether the acquisition, management, or disposition of the **property** was directly connected with the taxpayer's business operations. American Smelting at 931, 592 P.2d at 46 ("business income

includes . . . income from tangible and intangible property if that property has the requisite connection with the corporation's trade or business."). Property that is not directly connected to the taxpayer's trade or business operations, such as passive investment property, does not generate business income. As pointed out in the American Smelting case:

> In our view, in order for such income to be properly classified as business income there must be a more direct relationship between the underlying asset and the taxpayer's trade or business. The incidental benefits from investments in general, such as enhanced credit standing and additional revenue, are not, in and of themselves, sufficient to bring the investment within the class of property the acquisitions, management or disposition of which constitutes an integral part of the taxpayer's business operations. This view furthers the statutory policy of distinguishing that income which is truly derived from passive investments from income incidental to and connected with the taxpayer's business operations.

Id. at 933, 592 P.2d at 48.

The important distinction under the functional test is whether the property was directly connected with the taxpayer's business activity or whether it was merely a passive investment. In addition, there is a strong presumption under Idaho law that income derived from stock or other securities is business income. Idaho Code § 63-3027(a)(1) ("Gains or losses and dividend and interest income from stock and securities of any foreign or domestic corporation shall be presumed to be income from intangible property, the acquisition, management, or disposition of which constitute an integral part of the taxpayer's trade or business; such presumption may only be overcome by clear and convincing evidence to the contrary.") Thus, the burden is clearly on the taxpayer to establish that the gains and losses from the sale of stock or other securities is nonbusiness income.

In the present protest, the taxpayer asserts that [Redacted] operated entirely independently from the [Redacted] unitary group and, as a result, the taxpayer's ownership interest in [Redacted] should be treated as a passive investment. There appears to be some merit

to this argument. However, there is also evidence in the record to indicate that the joint venture with [Redacted] that resulted in the creation of [Redacted] was directly connected to the taxpayer's trade or business operations. Namely, [Redacted] was created to market and distribute [Redacted], which fits squarely within the [Redacted] line of business. In fact, one of the segregated divisions of [Redacted] as reported on the company's consolidated annual report to shareholders is the [Redacted] According to the [Redacted]:

[Redacted]
Thus, [Redacted], through its ownership interest in [Redacted], had the exclusive right to market and distribute [Redacted] [Redacted] in the United States and Canada. This connection between the creation and ownership of [Redacted]. and the ability of [Redacted] to profit from its exclusive marketing and distribution rights amounts to more than just the passive investment of idle funds.

While this is a close case, the Tax Commission finds that the acquisition of the 50% interest in [Redacted] constituted an integral part of the taxpayer's unitary business operations. The acquisition of the stock was directly connected to the ability of the taxpayer to profit from the marketing and distribution of the [Redacted]. In short, this direct connection between the income generated from the creation and operation of [Redacted] unitary group of companies, when coupled with the statutory presumption in favor of classifying gain on the sale of stock as business income, is sufficient to uphold the auditor's reclassification of the gain as business income.

3. Constitutional Considerations -- Unitary Business Income.

Having determined that the gain on the sale of the [Redacted] stock is properly treated as business income under the Idaho statute, we next examine the relevant federal constitutional limitations. In a series of cases culminating in Allied-Signal, Inc. v. Director, Div. of Taxes, 504 U.S. 768, 112 S.Ct. 2251 (1992), the United States Supreme Court has provided an analytical

framework for determining the constitutional restraints on state apportionment of income.[1] The starting point is the recognition that the Due Process clause and the Commerce Clause of the United States Constitution preclude states from taxing nondomiciliary corporations on income "derived from unrelated business activity which constitutes a discrete business enterprise" with no connection to the taxing state. Allied-Signal at 773, 112 S.Ct. at 2255 (*quoting* Exxon Corp. v. Wisconsin Dept. of Revenue, 447 U.S. 207, 224, 100 S.Ct. 2109, 2120 (1980)) (internal quotations and modifications omitted). Put another way:

> The Due Process and Commerce Clauses of the Constitution do not allow a State to tax income arising out of interstate activities -- even on a proportional basis -- unless there is a " 'minimal connection' or 'nexus' between the interstate activities and the taxing State, and 'a rational relationship between the income attributed to the state and the intrastate values of the enterprise.' " *Exxon Corporation v. Wisconsin Dept. of Revenue*, 447 U.S., at 219-220, 100 S.Ct., at 2118, *quoting Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S., at 436, 437, 100 S.Ct., at 1231. At the very least, this set of principles imposes the obvious and largely self-executing limitation that a State not tax a purported "unitary business" unless at least some part of it is conducted in the state. See *Exxon Corp*., 447 U.S., at 220, 100 S.Ct., at 2118; *Wisconsin v. J.C. Penney Co*., 311 U.S. 435, 444, 61 S.Ct. 246, 249, 85 L.Ed. 267 (1940).

Container Corporation of America v. Franchise Tax Board, 463 U.S. 159, 165-166, 103 S.Ct. 2933, 2940 (1983).

The Supreme Court provided some insight into the breadth of the constitutional limitation on apportionment of income in Mobil Oil Corp. v. Comm'r of Taxes, 445 U.S. 425, 100 S.Ct. 1223 (1980), where the Court stated that "the linchpin of apportionability in the field of state income taxation is the unitary-business principle." *Id.* at 439, 100 S.Ct. at 1232. In short, income derived from the unitary business of the taxpayer may be apportioned among the various states in which the

[1] The alluded to cases are Mobil Oil Corp. v. Comm'r of Taxes, 445 U.S. 425, 100 S.Ct. 1223 (1980); ASARCO, Inc. v. Idaho State Tax Comm'n, 458 U.S. 307, 102 S.Ct. 3103 (1982); F.W. Woolworth Co. v. Taxation and Revenue Dept., 458 U.S. 354, 102 S.Ct. 3128 (1982); Container Corporation of America v.

taxpayer conducts its unitary business. Such apportionment is consistent with the federal limitations found in the Due Process and Commerce clauses. As described by one commentator:

> Under the unitary business principle, if a taxpayer is carrying on a single "unitary" business within and without the state, the state has the requisite connection to the business' out-of-state activities to justify the inclusion of all of the income generated by the combined effect of the out-of-state and in-state activities in the taxpayer's apportionable tax base. By the same token, if the taxpayer's income-producing activities carried on within the state are not unitary with its income-producing activities carried on elsewhere, the state is constitutionally constrained from including the income arising from those out-of-state activities in the taxpayer's apportionable tax base. Although it was not until 1980 that the Court declared that "the linchpin of apportionability in the field of state income taxation is the unitary business principle," this principle, as the Court recognized, was not "new." Indeed, even at the time it had "been a familiar concept in our tax cases for over sixty years."

Walter Hellerstein, MULTISTATE TAX PORTFOLIOS § 1190:02.A.1 (Footnotes omitted).

In Allied-Signal the Court reaffirmed the unitary business principle as the linchpin of apportionability. According to the Court:

> [T]he unitary business rule is a recognition of two imperatives: the States' wide authority to devise formulae for an accurate assessment of a corporation's intrastate value or income; and the necessary limit on the States' authority to tax value or income which cannot in fairness be attributed to the taxpayer's activities within the State.

Allied-Signal at 780, 112 S.Ct. at 2259. The Allied-Signal Court then went on to describe the two occurrences where apportionment of income from intangibles will be allowed under the unitary business principle. First, apportionment will be permitted if there is unity between the payor and the payee. That is, apportionment is permitted if the payor and the payee are engaged in the same unitary business. It was this payor-payee unity that was at issue in Mobil (unity found), ASARCO (unity not found), and F.W. Woolworth (unity not found). Payor-payee unity is dependent on the

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Franchise Tax Bd., 463 U.S. 159, 103 S.Ct. 2933 (1983); and Allied-Signal, Inc. v. Director, Div. of Taxes, 504 U.S. 768, 112 S.Ct. 2251 (1992).

relationship of the payor and payee corporations. The analysis focuses on the tried and true indicia of unity: (1) functional integration, (2) economies of scale, and (3) centralized management.[2]

The second occurrence upon which apportionment of income from intangibles will be permitted is if the capital transaction from which the income is derived "serves an operational function" as opposed to an "investment function." *Id.* at 788, 112 S.Ct. at 2263 - 2264. "The essential question under the operational-function test is whether the intangible asset is part of the corporate taxpayer's own unitary business, not whether two separate corporations are engaged in a common enterprise." Walter Hellerstein, State Taxation of Corporate Income From Intangibles: Allied-Signal And Beyond, 48 Tax L. Rev. 739, 791 n.315. It was this operational function test which was at issue in Allied-Signal and which is at issue in this protest with respect to the gain from the sale of the stock of [Redacted].

The United States Supreme Court in Allied-Signal clearly indicates that a taxpayer can derive apportionable unitary income from an operational transaction even though there is no unity between the payor corporation and the payee corporation. Unfortunately, the Court left this operational-function test largely undefined. The Court did, however, provide one practical example of operational unity. According to the Court, "a State may include within the apportionable income of a nondomiciliary corporation the interest earned on short-term deposits in a bank located in another state if that income forms part of the working capital of the corporation's unitary business, notwithstanding the absence of a unitary relationship between the corporation and the bank." *Id.* at 787-788, 112 S.Ct. at 2263. Thus, income earned on the investment of idle working capital can constitutionally be apportioned among the various states in which the corporation conducts its unitary business operations.

[2] For a more in-depth discussion of this type of unitary relationship, see part III.C of this Decision.

The Court also gave us a clue to the breadth of this operational-function test when it cited footnote 19 of Container Corporation of America v. Franchise Tax Bd. In footnote 19 of Container Corp., Justice Brennen, writing for the majority, stated that "[a]s we made clear in another context in *Corn Products Co. v. Commissioner*, 350 U.S. 46, 50-53, 76 S.Ct. 20, 23-24, 100 L.Ed. 29 (1955), capital transactions can serve either an investment function or an operational function." Container Corp. at 180 n.19, 103 S.Ct. at 2948 n.19. It is this distinction between investment and operational functions that is at the heart of the operational-function test set forth in Allied-Signal. In general terms, if a capital transaction serves an operational function, the income derived therefrom will be treated as part of the corporation's unitary business and is subject to apportionment. Conversely, if the transaction serves an investment function, then the income derived therefrom cannot be taxed by a nondomicilary state unless (1) the investment transaction took place, at least in part, in that state, or (2) payor-payee unity exists.

Another important point that can be gleaned from the language in footnote 19 of Container Corp. is that transactions other than the short-term investment of idle working capital may meet the operational-function test. The fact that the Court cites with approval the Corn Products Co. v. Commissioner decision is key. As explained by Professor Hellerstein:

> In *Corn Products*, the Supreme Court held that a company engaged in converting corn into syrup and other products realized ordinary income and loss on the sale of corn futures even though such futures were not literally excluded from the "capital asset" definition under I.R.C. § 1221. Because the taxpayer's transactions in corn futures were designed to protect its manufacturing operations against increases in the cost of its principal raw material and to assure a ready source of supply of corn if needed, the Court held that the resulting profits and losses should be characterized consistently with Congress' perceived intent "that profits and losses arising from the everyday operation of a business be considered as ordinary income or loss rather than capital gain or loss." *Corn Products*, 350 U.S. at 52.
>
> The case spawned the doctrine under which gain or loss from the sale of intangible assets, frequently stock in other corporations,

> was held to be ordinary gain or loss because the asset was "**bought and kept not for investment purposes, but only as an incident to the conduct of the taxpayer's business**." *John J. Grier Co. v. United States*, 328 F.2d 163, 165 (7th Cir. 1964). . . .
>
> Income from intangible assets falling under the Corn Products doctrine thus would be apportionable under the operational-function test. . . .

Hellerstein, State Taxation Of Corporate Income From Intangibles: Allied-Signal and Beyond, 48 Tax L. Rev. 739, 793-94 n.319 (emphasis added).

Applying the operational-function test to the facts in the present dispute, the Tax Commission finds that the acquisition of [Redacted] served an operational function as opposed to an investment function. This finding is based on essentially the same factors that have led us to find that the gain from the sale of [Redacted] is business income under the statutory "functional" test. Based on the record currently before this Commission, it appears that the acquisition of the stock of the non-unitary subsidiary was directly connected to the ability of the taxpayer to profit from the marketing and distribution of the [Redacted]line of quality [Redacted]. Under the United States Supreme Court's holding in Allied-Signal, the gain recognized on the sale of that stock is therefore constitutionally apportionable. As a result, we hereby uphold the audit staff's reclassification of the gain from the sale of [Redacted] as apportionable business income.

C. Inclusion of [Redacted] **Unitary Group.**

1. Introduction.

The third issue raised in this protest involves two "Delaware holding companies" that were set up by [Redacted] to hold and manage certain trade names, trademarks and service marks.[3] The two holding companies, [Redacted], were incorporated in Delaware to take

[3] For a more in-depth recitation of the facts relating to the creation of SWIMC, Inc. and DIMC, Inc. see Sherwin Williams & Co. v. Massachusetts Comr. of Rev., 778 N.E.2d 504 (Mass. 2002).

advantage of the beneficial legal climate of that state. As set forth in the letter of protest dated May 23, 2003:

> [Redacted]were established to hold and manage, U.S. trade names, trademarks and service marks . . . and enter into licensing arrangements for the use of the trademarks. [Redacted] were formed for valid business purposes and carry on substantial business activities.
>
> . . . The reason these corporations were established in Delaware is due to the favorable business climate for corporations. The overall legal climate for corporations in Delaware is considered to be among the most stable[], predictable and consistent of any states.

Letter of protest, p. 3.

[Redacted] owns directly or indirectly 100% of the outstanding stock of these two subsidiaries. During the telephone informal conference held February 26, 2004, the representative for [Redacted] explained that [Redacted] owns and manages trade names and trademarks relating to the [Redacted] "architectural" line of [Redacted], while [Redacted] owns and manages trade names and trademarks relating to the [Redacted]. Both subsidiaries, according to the taxpayer's representative, were formed for valid business reasons and should be treated as separate business entities.[4] From this initial premise, [Redacted] goes on to assert that both of these subsidiaries are independently managed and are not part of the [Redacted]unitary group of companies. In support of this rather remarkable claim that [Redacted]unitary group, the

[4] Under what is known as the "sham transaction doctrine," courts and tax administrative agencies may "disregard, for taxing purposes, transactions that have no economic substance or business purpose other than tax avoidance." Sherwin Williams & Co. v. Massachusetts Comr. of Rev., 778 N.E.2d 504, 512 (Mass. 2002) (quoting Syms Corp. v. Commissioner of Revenue, 765 N.E,2d 758, ___ (Mass. 2002). Whether SWIMC, Inc. and DIMC, Inc. have sufficient economic substance to be considered separate business entities (as opposed to "sham transactions") is an issue that is currently being litigated in several states. *Compare* Sherwin Williams & Co. v. Massachusetts Comr. of Rev., 778 N.E.2d 504 (Mass. 2002) (sufficient economic substance to be considered a separate legal entity) with In re Sherwin Williams Co., DTA No. 816712 (N.Y. Tax App. Trib. 2003) (insufficient economic substance). For reasons discussed below, the Idaho State Tax Commission takes no position on this factual issue. Even if SWIMC and DIMC are treated as separate legal entities, they are still part of the Sherwin-Williams unitary group of companies and are to be included in the Idaho combined group returns for each of the years at issue in this administrative protest.

taxpayer's representative points out that: (1) the day-to-day operations of the two holding companies are not managed by or directed by [Redacted]; (2) only two officers of [Redacted] are on the Board of Directors of [Redacted]; (3) the two holding companies have actual employees doing actual day-to-day business activity at the corporate offices in Delaware; (4) the holding companies "transact with independent third parties in the ordinary course of business, including banks, accountants, lawyers, and landlords"; (5) the two holding companies are in a different line of business from [Redacted]; (6) the royalty payments made by [Redacted] for the use of the trademarks and other intellectual property owned and managed by [Redacted] are based on arms-length royalty rates; and (7) [Redacted] have on occasion entered into trademark and trade name licensing agreements with independent third parties. According to the taxpayer, these factors establish that [Redacted] are operated and managed independently from [Redacted] and, therefore, are not part of the [Redacted] unitary group of companies. The Tax Commission is not convinced.

2. Overview of the Unitary Business Concept.

Before moving to the merits of the taxpayer's argument, it may be useful to provide an overview of the unitary business concept. Generally speaking, a unitary business is a single economic enterprise that is made up of a group of commonly owned or controlled business entities. Prior to the advent of the unitary business concept in the early 1900s, most States generally determined the amount of income earned within their borders by applying separate accounting principles to each separate business entity. However, by the early part of the twentieth century, with the growing size and complexity of multistate businesses, the separate accounting method of measuring taxable income proved to be unsatisfactory. Because large corporations typically do business through networks of interlocking subsidiaries and divisions,

enabling the enterprise to shift income, expenses, property, payroll, and sales among its various subsidiaries and divisions at will, the States sought a way to more accurately account for and tax the in-state income of these multistate (and often multi-entity) business enterprises. This led to the development of the unitary business concept. The unitary business concept -- as refined through the requirement of "combined reporting" -- treats a group of commonly owned businesses as a single unit for purposes of allocating and apportioning the income of that enterprise among the various states where it conducts its business operations. See generally, Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159, 164 – 169, 103 S.Ct. 2933, 2940 – 2942 (1983) (discussing the unitary business principle in light of the California combined reporting requirement).

Whether two or more business entities constitute a unitary business is a factual determination that has spawned considerable litigation over the years. A primary reason for this is that there is no clearly established definition of what constitutes a unitary business. Rather, courts have articulated several different definitions or standards that can be used to determine whether a group of commonly owned businesses are engaged in a single unitary enterprise. And even within these different definitions of what constitutes a unitary business, there is an unmistakable level of subjectivity. While the decision maker will be presented with various facts that either weigh for or against a finding of unity, in many cases reasonable people can disagree whether the weight of the evidence tips the scales in one direction or the other. But for all its problems and shortcomings, the unitary business principle is the backbone of modern state corporate income tax law. Formula apportionment, such as is required by Idaho Code § 63-3027, would not be possible absent the advent and development of the unitary business principle. See Mobil Oil Corp. v. Com'r of Taxes of Vermont, 445 U.S. 425, 439, 100 S.Ct. 1223, 1232 (1980)

("the linchpin of apportionability in the field of state income taxation is the unitary-business principle.")

The use of formula apportionment to determine the amount of income of a unitary business that is subject to tax by a state was first upheld by the United States Supreme Court in Underwood Typewriter Co. v. Chamberlain, 254 U.S. 113, 41 S.Ct. 45 (1920). In approving the state of Connecticut's formula apportionment method, the Court opined that the state's method of measuring the amount of income from activities taking place within the state was at least as accurate, if not more so, than the separate accounting method advocated by the taxpayer. *Id.* at 120 – 121, 41 S.Ct. at 47. More importantly, the Court held that the taxpayer had not met its burden of showing that the state's apportionment formula method resulted in the taxation of income that was unrelated to business activities taking place within the state.

The holding in Underwood Typewriter was amplified a few years later in Bass, Ratcliff & Gretton, Ltd v. State Tax Comm'n, 266 U.S. 271, 45 S.Ct. 82 (1924), where the Supreme Court used for the first time the term "unitary business" in describing an interconnected multistate business enterprise:

> So in the present case we are of opinion that, as the Company carried on the **unitary business** of manufacturing and selling ale, in which its profits were earned by a series of transactions beginning with manufacture in England and ending in sales in New York and other places – the process of manufacturing resulting in no profits until it ends in sale – the State was justified in attributing to New York a just proportion of the profits earned by the Company from such **unitary business**.

Id. at 282, 45 S.Ct. at 84 (emphasis added). While the Supreme Court utilized the term "unitary business," it did not go on to define that term. It was actually the California Supreme Court in Butler Bros. v. McColgan, 111 P.2d 334 (1941), *aff'd* 315 U.S. 501, 62 S.Ct. 701 (1942), that

first provided some insight into what factors are relevant in determining the existence of a unitary business.

In Butler Bros., the taxpayer operated a wholesale dry goods and general merchandising business, purchasing from manufacturers and selling only to retailers. The taxpayer had set up several wholesale distributing houses throughout the United States, including one in California. Each of these wholesale distributing houses maintained its own set of books and accounted for its own sales. In addition, each distributing house incurred direct operating expenses which were charged against income; and each distributing house also claimed indirect expenses relating to the overall business enterprise such as executives salaries, corporate overhead, and centralized advertising. These indirect expenses were allocated among the various distributing houses in accordance with recognized accounting principles. This "separate accounting" approach resulted in the taxpayer claiming that it suffered an operating loss from its activities in California even though the corporation recognized an overall profit.

The California taxing authority disallowed the separate accounting treatment used to compute the taxpayer's California income tax liability and, instead, required the company to employ an apportionment formula. On appeal to the California Supreme Court, the issue was framed as follows:

> The sole question to be determined on this appeal is whether it is lawful and proper for the [Franchise Tax Commissioner] to insist upon use of the formula for allocation of income in a case such as this, or whether the company is entitled to use the separate accounting of its San Francisco house to determine its net income in the state of California. The answer to this question depends entirely on the nature of the business conducted within and without the state by [the taxpayer], a foreign corporation. It is only if its business within this state is truly separate and distinct from its business without this state, so that the segregation of income may be made clearly and accurately, that the separate accounting method may properly be used. Where, however, interstate operations are carried on and that portion of the corporation's business done within the state cannot be

> clearly segregated from that done outside the state, the unit rule of assessment is employed as a device for allocating to the state for taxation its fair share of the taxable values of the taxpayer.

Butler Brothers v. McColgan, 111 P.2d 334, 336 (Cal. 1941). The California Supreme Court then went on to uphold the California apportionment method. In doing so, the California Supreme Court held that Butler Brothers was engaged in a single unitary business. Factors relied upon by the California Supreme Court to support its finding of unity were the presence of "(1) Unity of ownership; (2) Unity of operation as evidenced by central purchasing, advertising, accounting and management divisions; and (3) unity of use in its centralized executive force and general system of operations." *Id.* at 341 These factors (unity of ownership, unity of operation, and unity of use) have since become known as the "three unities" test. While not expressly embracing the "three unities" test employed by the California Supreme Court, the United States Supreme Court went on to uphold the lower court's finding that Butler Brothers was engaged in a unitary business and that formula apportionment was a constitutionally permissible way to determine the amount of income from that unitary business that was fairly attributable to business activities taking place in California. 315 U.S. 501, 62 S.Ct. 701 (1942)

The California Supreme Court was also instrumental in establishing another test or standard that can be employed in determining whether a group of commonly owned corporations are engaged in a unitary business. In Edison California Stores, Inc. v. McColgan, 183 P.2d 16 (Cal. 1947), the California Supreme Court articulated what has since come to be known as the "contribution - dependency" test. As succinctly set forth by the California Supreme Court: "If the operation of the portion of the business done within the state is dependent upon or contributes to the operation of the business without the state, the operations are unitary; otherwise, if there is no such dependency, the business within the state may be considered to be separate." *Id.* at 21.

The Idaho Supreme Court has cited with approval both the three unities test set out in Butler Brothers and the contribution – dependency test first articulated in Edison California Stores. See Albertson's Inc. v. State, Dept. of Rev., 106 Idaho 810, 815 - 816, 683 P.2d 846, 851 - 852 (1984).

A third test that is commonly used in determining the existence of a unitary business was set out by the United States Supreme Court in Mobil Oil Corp. v. Com'r of Taxes of Vermont, 445 U.S. 425, 100 S.Ct. 1223 (1980). In that case, Vermont asserted that dividends received by Mobil Oil Corporation from certain of its wholly or majority owned subsidiaries should be included as business income, a portion of which was attributable to the State of Vermont based on a statutory apportionment formula. In response Mobil Oil Corporation pointed out that none of these subsidiaries conducted any business activity within Vermont and, therefore, in a separate accounting sense the dividend income was derived from business activities unrelated to Mobil Oil Corporation's Vermont activities. In rejecting Mobil Oil's argument and holding that the dividend income could constitutionally be included in the Vermont pre-apportionment tax base, the U.S. Supreme Court found that Mobil Oil had failed to establish that the subsidiaries in question were not part of its unitary petroleum operations. In doing so, the Supreme Court opined that "separate accounting, while it purports to isolate portions of income received in various States, may fail to account for contributions to income resulting from functional integration, centralization of management, and economies of scale." *Id.* at 438, 100 S.Ct. at 1232. The Court then went on to state that "[b]ecause these factors of profitability [functional integration, centralized management, and economies of scale] arise from the operation of the business as a whole, it becomes misleading to characterize the income of the business as having a single identifiable 'source.' Although separate geographical accounting may be useful for internal auditing, for purposes of state taxation it is not constitutionally required." *Id.*

The Mobil Oil "factors of profitability" have been cited with approval in subsequent U.S. Supreme Court cases as one permissible method of identifying a unitary business. *See, e.g.*, F.W. Woolworth Co. v. Taxation & Rev. Dept., 458 U.S. 354, 364 - 370, 102 S.Ct. 3128, 3135 - 3138 (1982) (finding little or no evidence of functional integration, centralization of management, or economies of scale). However, in Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159, 103 S.Ct. 2933 (1983), the Court, while citing the Mobil "factors of profitability" with approval, also made clear that the overarching inquiry in determining whether two or more enterprises are engaged in a unitary business is the existence of a "sharing or exchange of value not capable of precise identification or measurement – beyond the mere flow of funds arising out of a passive investment or a distinct business operation – which renders formula apportionment a reasonable method of taxation." *Id.* at 166, 103 S.Ct. at 2940. The above quoted passage is particularly insightful in that it set the parameters of a unitary business by explaining what it is not. A unitary business is not a passive investment and is not a distinct business operation. But where the facts and circumstances establish an interrelationship or flow of values that goes beyond a mere passive investment or a distinct business operation, it is likely that a unitary relationship exists "which renders formula apportionment a reasonable method of taxation."

As evidenced by the court decisions discussed above, there is no bright-line test that can be employed in determining whether two or more business entities are engaged in a unitary business. "Unity can be established under any one of the judicially acceptable tests (Butler Bros., Edison California Stores, Container, etc.), and cannot be denied merely because another of those tests does not simultaneously apply." California Franchise Tax Board Notice 92-4, 1992 WL 207038. In addition, all these various definitions are for the most part subjective in nature.

In some circumstances, determining that a group of companies is engaged in a unitary business can be quite easy. For example, a unitary business will almost always exist where the commonly owned corporations are all directly or indirectly engaged in a single line of business, or where the commonly owned corporations are all directly or indirectly engaged in one or more steps in a vertical process. However, the question becomes much harder where the commonly owned businesses are not engaged in the same line of business and are not engaged in one or more steps along a vertical process. In these cases the finding of a unitary business often comes down to a subjective weighing of the various indicia of unity such as functional integration, centralization of management, and economies of scale.

3. [Redacted] **under the Contribution – Dependency Test.**

In the present case, the Tax Commission has no doubt that [Redacted] are part of the [Redacted] unitary group of companies. It is, in fact, quite remarkable that [Redacted] is even pressing this issue in light of the difficulty the company is having in separate-reporting states with convincing the various tax agencies and courts that its two Delaware holding companies were created for legitimate business reasons. To assert that these two subsidiaries are not only legitimate economic entities, but also that they are functionally and operationally independent from the [Redacted] unitary group, is astonishing. The unitary business doctrine – when used in tandem with combined reporting – was developed in large part to put a stop to the very kind of "entity isolation" tax maneuvering that [Redacted] is engaged in with respect to its two Delaware holding companies.

[Redacted] in early 1991 "to hold and manage the [Redacted] marks and to invest and manage royalty proceeds earned therefrom." [Redacted] Both subsidiaries are 100% owned directly or indirectly by [Redacted]. Two of the four members of the [Redacted] boards of

directors are officers of [Redacted]. The articles of organization and the bylaws of both [Redacted] restrict the lease, sale, exchange, transfer, assignment, or disposition of any of the assets with a value of $52,000 or more without the approval of [Redacted]. In fact, it appears that the only action that can be taken unilaterally by the directors of [Redacted] with respect to the trade names, trademarks and service marks is to license those marks and trade names to third parties. But even with this authority to license the marks and trade names to third parties, approximately 99% of the royalty income received by these two Delaware holding companies was from the [Redacted] group of companies during the years at issue in this protest. It is also worth noting that the two holding companies were treated by [Redacted] as part of its unitary group in the years prior to the 1998 taxable year, and all of the royalty and interest expense incurred by [Redacted] and its unitary subsidiaries in its dealings with [Redacted] were treated as business expenses.

Under the "contribution – dependency" test set out in Edison California Stores, there can be no question that these two holding companies are part of the [Redacted] unitary group. The operations of the two intangible holding companies contribute in a meaningful way to the business operations of the [Redacted] group of companies; and the two holding companies are dependent upon [Redacted] for the vast majority of the royalty and interest income that they earn. The economic interrelationship between the holding companies and the parent corporation is unmistakable. The subsidiaries rely on the parent for 99% of its royalty income, and the parent relies on the subsidiaries for the right to use and exploit valuable trademarks and trade names. Furthermore, each of the subsidiaries was created by the parent, and each is 100% owned directly or indirectly by the parent. Finally, most, if not all, of the trade names, trademarks and service marks owned and managed by the two subsidiaries were originally

developed and registered by the parent and were transferred to the subsidiaries as part of the parent's overall business strategy. Based on these facts, the Tax Commission has no trouble finding that [Redacted] are part of the [Redacted] unitary group.

4. [Redacted] are Unitary with [Redacted] under the Mobil Factors of Profitability Test.

There is also ample evidence to support a finding of unity under the "factors of profitability" test set out in Mobil Oil Corp. v. Com'r of Taxes of Vermont, 445 U.S. 425, 100 S.Ct. 1223 (1980). In Mobil Oil, the taxpayer "attempted to characterize its ownership and management of subsidiaries and affiliates as a business distinct from its sale of petroleum products in this country." *Id.* at 440, 100 S.Ct. at 1233. In rejecting this contention, the Supreme Court "noted that separate accounting, while it purports to isolate portions of income received in various States, may fail to account for contributions to income resulting from functional integration, centralization of management, and economies of scale. Because these factors of profitability arise from the operation of the business as a whole, it becomes misleading to characterize the income of the business as having a single identifiable 'source.'" *Id.* at 438, 100 S.Ct. at 1232. The Supreme Court also did not "find particularly persuasive Mobil's attempt to identify a separate business in its holding company function. So long as dividends from subsidiaries and affiliates reflect profits derived from a functionally integrated enterprise, those dividends are income to the parent earned in a unitary business." *Id.* The Supreme Court continued:

> [T]he form of business organization may have nothing to do with the underlying unity or diversity of business enterprise. Had [Mobil] chosen to operate its foreign subsidiaries as separate divisions of a legally as well as a functionally integrated enterprise, there is little doubt that the income derived from those divisions would meet due process requirements for

> apportionability. Transforming the same income into dividends from legally separate entities works no change in the underlying economic realities of a unitary business, and accordingly it ought not to affect the apportionability of income the parent receives.
>
> We do not mean to suggest that all dividend income received by corporations operating in interstate commerce is necessarily taxable in each State where that corporation does business. Where the business activities of the dividend payor have nothing to do with the activities of the recipient in the taxing State, due process considerations might well preclude apportionability, because there would be no underlying unitary business. We do not decide, however, whether Vermont's tax statute would reach extraterritorial values in an instance of that kind. Mobil has failed to sustain its burden of proving any unrelated business activity on the part of its subsidiaries and affiliates that would raise the question of nonapportionability.

Id. at 440 – 441, 100 S.Ct. 1233. (Citations and footnote omitted).

Applying the factors of profitability to the facts of the present case, the Tax Commission finds that [Redacted] has failed to carry its burden of showing that [Redacted] are discrete business enterprises whose income is unrelated to the taxpayer's unitary business operations. As pointed out above, there is significant functional integration between the two subsidiaries and their parent. This functional integration is exemplified by the transfer of the [Redacted] marks and trade names to the holding companies and the corresponding licensing of those same marks and trade names back to [Redacted]. Paraphrasing the U.S. Supreme Court in Mobil, had [Redacted] chosen to retain the ownership and management of its trademarks, trade names and service marks within a separate division of a legally as well as a functionally integrated enterprise, there is little doubt that the income derived from that division would meet due process requirements for apportionability. Transforming the same income into royalties from legally separate entities works no change in the underlying economic realities of a unitary business, and accordingly it ought not to affect the apportionability of income the parent receives.

> There is also evidence of beneficial economies of scale resulting from the economic interrelationship between [Redacted] and its two Delaware holding companies. While the "underlying economic realities" relating to the transfer of valuable trademarks and trade names into a wholly owned holding company makes this factor less important than it would be in determining a unitary relationship between two operating entities, there is still a benefit to the [Redacted] group of companies that can loosely be described as resulting from economies of scale. This benefit was aptly described in the letter of protest filed on behalf of [Redacted] The consolidation of the U.S. trademarks, trade names, and service marks into subsidiaries that are under a separate and distinct management team benefits [REDACTED] in numerous ways. It allows the investments to be insulated from the liabilities faced by the parent company. The parent company has greater flexibility in preventing a hostile takeover attempt through the expeditious sale of either [Redacted]. Such a sale would raise cash to fight the takeover attempt, while making the parent company a less-attractive target. Without a separate corporate structure already in place, it would be extremely difficult to separate the intangible assets from the rest of the parent company operations and sell them quickly enough to prevent the hostile takeover. . . .

Letter of protest, p. 3. Thus, [Redacted] benefits from its relationship with [Redacted] in ways that it could not if those two subsidiaries were truly discrete and unrelated business enterprises. Although this benefit may not be "capable of precise identification or measurement," Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159, 166, 103 S.Ct. 2933, 2940 (1983), it is the sort of benefit the U.S. Supreme Court referred to in Mobil as "contributions to income resulting from . . . economies of scale."

The final factor of profitability referred to by the U.S. Supreme Court in Mobil is centralization of management. Strong centralized management is often a hallmark of a unitary business operation. During the informal conference, the representative of [Redacted] argued that this factor is missing in the present case and, therefore, the two wholly owned subsidiaries were not unitary with [Redacted] and the other members of the [Redacted] unitary group. While it is true that in the present case "centralization of management" is the weakest of the Mobil factors of profitability, the Tax Commission does not agree that this factor is missing. In analyzing this

factor, it is helpful to consider the backdrop surrounding the formation of [Redacted]. This factual backdrop has been painstakingly set forth by the Massachusetts Supreme Judicial Court in [Redacted] Particularly relevant is the following description of the restrictions placed on the management of [Redacted]:

> The article of organization of both [Redacted] provided that their activities would "be confined to the maintenance and management of its intangible investments." The articles also placed restrictions and prohibitions on the subsidiaries, providing that neither [Redacted] could "lease, sell, exchange, transfer, license, assign (except to affiliates), or dispose of any of the assets of the Corporation (except for assets having a value under $52,000)" in the absence of approval by the holder of the majority of shares. In addition, neither subsidiary could pledge any of its assets without the approval of a majority of stockholders. These restrictions were reiterated in the bylaws for both corporations. The articles and bylaws were subsequently amended to eliminate stockholder approval for the licensing of the marks to conform with the subsidiaries' practice of entering license agreements without securing stockholder approval.

Id. at 511.

In light of this factual backdrop, it is clear that most of the major decision-making authority one would expect to see in a truly independent business entity was taken away from the management of [Redacted]. While the management of those two holding companies was given autonomy to manage day-to-day business operations and to license the trademarks and trade names to independent third parties, any unilateral managerial authority stops there. With the exception of assets having a value under $52,000, the management of [Redacted] had no ability to sell, lease, assign, transfer or dispose of any of its trade names, trademarks and service marks without approval of [Redacted]. In addition, it appears that [Redacted] management and oversight of its trade names, trademarks and service marks actually became more centralized as a result of the creation of [Redacted]. *See Id.* at 512 (discussing the concerns some of the [Redacted] senior corporate managers had prior to the formation of [Redacted] regarding "the

multiple divisions of [Redacted], its decentralized management and culture, and the use of many of the marks across divisions creat[ing] uncertain authority and diffus[ing] decision-making regarding the maintenance and exploitation of the marks, [and] contributing to their ineffective and inadequate management as a company asset.") At a minimum, [Redacted]continued to view the marks and trade names as valuable assets of the company and the creation of [Redacted] was part of a strategic decision by [Redacted] to better organize and utilize those assets.

There is no doubt that centralized management is an important factor in determining the existence of a unitary business. *See* ASARCO, Inc. v. Idaho State Tax Commission, 458 U.S. 307, 102 S.Ct. 3103 (1982) (Lack of active managerial control over foreign subsidiaries was a factor emphasized by the Supreme Court in finding that income received from the foreign subsidiaries was not apportionable business income.); F.W. Woolworth Co. v. Taxation and Revenue Dept., 458 U.S. 354, 102 S.Ct. 3128 (1982) (Decentralized management was a factor emphasized by the Supreme Court in overturning the lower court's finding of unity between F.W. Woolworth Company and its foreign subsidiaries.) But centralized management or active managerial control is not dispositive. If it were, then the U.S. Supreme Court in ASARCO and F.W. Woolworth would have applied a strict bright-line "centralization of management" test rather than also looking at functional integration and economies of scale as part of its overall "factors of profitability" inquiry. It is this Commission's considered opinion that ASARCO and F.W. Woolworth stand for the proposition that where underlying economic realities establish that income received from a subsidiary is derived from unrelated business activity which constitutes a discrete business enterprise, that income does not become subject to apportionment merely by the **potential** to operate the subsidiary as part of the taxpayer's unitary business. Those cases do

not establish a bright-line rule that actual control over the operations of the subsidiaries is always required in order to find a unitary relationship.

In Container Corp. of America v. Franchise Tax Board, 463 U.S. 159, 103 S.Ct. 2933 (1983), the U.S. Supreme Court stressed that in ASARCO "[w]e concluded . . . that a unitary business finding was impermissible because the partial[ly owned] subsidiaries were not realistically subject to even minimal control by ASARCO, and were therefore passive investments in the most basic sense of the term." *Id.* at 176 n.15, 103 S.Ct. at 2946 n.15. Thus, in analyzing its own prior decision, the U.S. Supreme Court stated that its holding in ASARCO was based on the fact that the subsidiaries were not realistically subject to even minimal control by the parent. That is a far cry from the facts presented in this protest where the two subsidiaries in question were formed by the parent as part of the parent's overall business strategy; both subsidiaries are 100% owed (directly or indirectly) by the parent; two of the four members of the board of directors of each of the subsidiaries are officers of the parent; and where major decisions regarding the transfer or sale of the assets of the subsidiary require approval of the parent. Under the circumstances, the Commission is unable to find that [Redacted]are "passive investments in the most basic sense of the term."

In any event, given the underlying economic realities relating to the formation of [Redacted], and the stringent restrictions placed on the management of those holding companies, the Commission finds that there is sufficient centralization of management between [Redacted]and its two wholly owned Delaware holding companies to weigh in favor of a finding of unity. More to the point, when analyzing all of the "factors of profitability" together, the Commission finds that [Redacted] has failed to carry its burden of showing that [Redacted]are discrete business enterprises whose income is unrelated to the taxpayer's unitary business

operations. As a result, the Commission's audit staff correctly concluded that those two holding companies were part of the [Redacted] unitary group during all of the years at issue in this administrative protest.

D. Imposition of the 10% Substantial Understatement Penalty.

The final issue to be addressed in this administrative protest is whether the 10% substantial understatement penalty should be waived. The substantial understatement penalty is set out in Idaho Code § 63-3046(d). Subsection (d)(7) provides that "[t]he state tax commission may waive all or any part of the [substantial understatement penalty] on a showing by the taxpayer that there was reasonable cause for the understatement (or part thereof) and that the taxpayer acted in good faith." I.C. § 63-3046(d)(7). With respect to the understatement of tax relating to the taxpayer's failure to include the gain from the sale of [Redacted] as apportionable business income, the Commission finds that there was reasonable cause for the understatement. As a result, the substantial understatement penalty is hereby waived with respect to the understatement of tax attributable to that audit adjustment. However, the Tax Commission is unable to find that the understatement in Idaho tax relating to the remaining audit adjustments was based on reasonable cause or that the taxpayer acted in good faith.

The vast majority of the understatement in tax at issue in this protest is attributable to the taxpayer's treatment of its two Delaware holding companies as non-unitary subsidiaries. As discussed above, the Commission finds no reasonable basis for this position. [Redacted] either did not make a good faith inquiry into the relevant legal standards for determining the existence of a unitary business relationship, or intentionally turned a blind-eye to the underlying facts and circumstances that clearly establish that [Redacted] are not discrete and independent business

enterprises. Under these circumstances, imposition of the substantial understatement penalty is appropriate.

IV.

CONCLUSION

To summarize, we agree with the taxpayer with respect to issue 1, but we uphold the audit staff with respect to issues 2 and 3. The substantial understatement penalty is waived to the extent it applies to the tax deficiency resulting under issue 2, but that penalty is upheld with respect to the tax deficiency resulting under issue 3 and with respect to the tax deficiency resulting from the audit adjustments that have been conceded by the taxpayer.

WHEREFORE, the Notice of Deficiency Determination dated March 26, 2003, is MODIFIED in accordance with the foregoing analysis, and as so Modified is hereby APPROVED, AFFIRMED AND MADE FINAL.

IT IS ORDERED and THIS DOES ORDER that the taxpayer pay the following taxes, penalty and interest:

Period	TAX	PENALTY	INTEREST	TOTAL
1997	$16,252	$1,625	$7,100	$24,977
1998	19,738	1,767	7,100	28,605
1999	16,616	1,662	4,756	23,034
2000	23,961	2,394	4,950	31,305
			Less partial payment made 5/23/03	(22,971)
			TOTAL AMOUNT DUE	$ 84,950

Interest is calculated through June 30, 2004, and will continue to accrue at the rate set forth in Idaho Code § 63-3045(6) until paid.

DEMAND for immediate payment of the foregoing amount is hereby made and given.

An explanation of the taxpayer's right to appeal this decision is enclosed with this decision.

DATED this _____ day of _____, 2004.

IDAHO STATE TAX COMMISSION

_____
COMMISSIONER

CERTIFICATE OF SERVICE BY MAIL

I hereby certify that I have on this ____ day of _____, 2004, served a copy of the within and foregoing DECISION by sending the same by United States mail, postage prepaid, in an envelope addressed to:

[REDACTED] Receipt No.

_____
COMMISSIONER